13.03 Deferred Tax Liabilities

Rog Co. prepays a $50 expense at the start of the year that is for the next 5 years. For book purposes our expense is $50/5 = $10/year as we are using accrual accounting. For tax purposes, we deduct all $50 today as we are using the cash basis. Assume the current tax rate is 20%, and the future rate is 30%.

	Book			Tax		
X1	Expense	10		Expense	50	
	Prepaid expense	40		Cash		50
	Cash		50			
X2	Expense	10		Expense	0	
	Prepaid		10	Cash		0

If income in X1 was $150 before this $50 expense and $200 in X2,

X1

$150

Book	Tax	
150	150	
–10	–50	
140	100	× 20% = $20 current tax liability

Difference is $40 which will reverse at $10 per year, if future tax rate is 30%, $40 × 30% = **$12 deferred tax liability**

X2

$200

Book	Tax	
200	200	
–10	–0	
190	200	× 30% = $60

Difference is $10, so the difference starts to reverse out. We then measure the remaining Liability of $30 (40-10) at the future tax rate of 30%, and that gives us a new **Target Liability of $9.**

Note: The cumulative difference is analyzed over time to determine the amount needed in the deferred tax liability account at year end.

The Journal entries would be:

X1	Income tax expense	32		(20 current/12 deferred)
	Deferred tax Liability		12	
	Current tax Liability		20	

X2	Income tax expense	57		(60 current/3 deferred)
	Deferred tax liability	3		(to get to target of $9)
	Current tax Liability		60	

The calculations of current and deferred taxes for 20X1 are:

Year	20X1	20X2	20X3	20X4	20X5
Taxable	100	0	0	0	0
Accounting	140	(10)	(10)	(10)	(10)
Difference	(40)	10	10	10	10
Rate	20%	30%	30%	30%	30%
Current tax	20				
Deferred tax		3	3	3	3 = 12

The current income tax expense on the $100 of taxable income at the effective 20% rate is $20, and is recorded as follows (assuming no prepayments):

Presentation on the Income Statement	X1		X2
Provision for income taxes			
Current	($20)	Current	($60)
Deferred	($12)	Deferred	$3
Total provision for income taxes	($32)		($57)

Note: The tax rate used is the **enacted tax rate**. That is the rate expected to be in effect when the temporary difference is paid or realized.

The *Effective Tax Rate* is the Average rate at which pretax profits are being taxed. It is calculated by taking the income tax expense divided by its net income before taxes.

Changes in Tax Law

ASC 740 requires any impact on deferred taxes due to changes in tax law (eg, change in tax rates) to be recognized in the reporting period that includes the **enactment date**. If a change is made during an *interim period*, an entity reflects the change in the estimated annual rate in the period of enactment instead of in the period that includes the effective date (a prospective transition approach).